26th Annual FAA Commercial Aviation Forecasting Conference
"Global Growth Opportunities for the New Millennium"
Breakout Session 1: Air Carrier Passengers
Washington D.C., 14 March 2001

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In Search of a More Efficient Regulatory Framework

► Like other key parameters, such as fuel prices and GDP, changes in the air transport regulatory framework have a direct and important bearing on the development of air transport and the airline industry. Traffic growth following both deregulation in the U.S. and the completion of the Single Market in the European Union testify thereto in no uncertain terms. It is therefore appropriate, at an aviation forecasting conference under the title "Global Growth Opportunities for the New Millennium", to consider what the prospects are for further regulatory change at the international level.

► The shift towards more market-oriented policies and the on-going globalisation of the economy are major driving forces in this respect. In international air transport it has led to the progressive removal of restrictions within the traditional bilateral regulatory system. Clearly, the U.S. 'open skies' program has significantly contributed to this development. The resulting greater freedom and increased competition made traffic move upwards and fares downwards, a process that went hand-in-hand with airline restructuring and reorganisation programs.

► However, globalisation, increased competition and industry restructuring are driving home the message that the bilateral system is far from ideal as regulatory basis for world air transport. It is the result of the inability of states, from the time when the Chicago Convention was drawn up, to agree on multilateral principles for trade in air transport services. Major weaknesses of the system are that:

- It's trade-facilitating effect is limited, as it varies from one bilateral agreement to another, depending on the trade interests and negotiating power of each of the two countries involved. It is therefore not surprising that the U.S., as economic superpower, has been able to conclude more than 50 'open skies' bilaterals but smaller liberal countries have not. This means that a true 'level playing field' can never be established under a bilateral system.

- Moreover, a bilateral instrument cannot accommodate complex international network traffic flows that are multilateral in nature. With the development of integrated, multi-carrier global networks the deficiencies of the bilateral approach become ever more visible.

► Recognizing the need to move beyond strict bilateralism the U.S. made a step forward in November 2000 when it signed a multilateral air transport agreement with four other APEC countries – Brunei, Chile, New Zealand and Singapore – based on the 'open skies' template. A principal merit of the agreement is that it extends the 'open skies' approach to air transport between countries other than the U.S., although at present the practical significance thereof is likely to be small. The size of the air transport market between the four other APEC countries is fairly small, and each of them was already conducting a relatively liberal air transport policy. Under these circumstances, the 'added liberalisation value' of the APEC multilateral for air transport between the parties is likely to be more a matter of form than of content. Of course, this could change if more APEC countries would join.

► Of particular interest also are the additional liberalisation measures under the APEC agreement, beyond the 'open skies' standard. These concern notably air cargo, airline ownership and wet-leasing:

- International all-cargo operations are fully liberalised, so that airlines also enjoy unrestricted 7th freedom rights.

- The traditional national ownership requirement is relaxed by allowing parties to the agreement to designate locally established airlines that are foreign owned.

- The traditional prohibition under U.S. laws for U.S. airlines to lease aircraft with crew from foreign airlines for air transport involving the U.S. is relaxed to the extent that U.S. airlines are allowed to wet-lease from non-U.S. airlines for the purpose of international air transport on the agreed routes.

► The U.S. authorities have hailed the APEC agreement as "historic", calling it a "giant step" that marks "the beginning of a new era". Upon analysis, however, the agreement appears to be of more modest proportions than suggested:

- First, the agreement is a traditional agreement in as much as it covers only international air transport by an airline of one party to and from the territories of the other parties. The U.S. domestic air transport market remains the exclusive domain of its own airlines. Access to that market by airlines of the other parties in the form of cabotage operations or by wet-leasing their aircraft to a U.S. airline remains out of reach. In principle, a separate Protocol to the Agreement envisages the possibility for airlines to carry cabotage traffic on international services, but reportedly the U.S. does not intend to sign up to it, because of its strong reluctance to open its domestic market to foreign competitors.

- Second, the agreement takes the ownership issue only a fairly small step forward. The right of establishment as a means of access to foreign markets remains entirely outside the scope of the agreement. The liberalisation of ownership gives a party the right to designate foreign owned airlines, but only as long as the foreign investor has no 'effective control', and with the additional proviso that a party may object to designations by other parties of airlines that are substantially owned by its own nationals. It is surprising that the agreement does not at least multilateralise the effective control condition, in the sense that a party could designate an airline that is not only substantially owned but also effectively controlled by nationals of any one or more of the other parties, instead of only the designating party. While the agreed change in the ownership rule gives airlines some additional flexibility as regards their capital structure, it continues to limit the scope for effective industry consolidation through international mergers and acquisitions, although such consolidation has become an urgent economic necessity for the airline industry, in order to ensure long term profitability. Regulatory problems experienced by European airlines in connection with intended mergers as well as the interest recently expressed by American Airlines in exploring a link with Sabena illustrate the need to modify today's rules and facilitate foreign investment in the airline industry.

- Third, with respect to wet-leasing the agreement does not seem to go much further than bringing the U.S. more into line with what is already normal practice in many other countries, by allowing U.S. airlines not only to lease-out but also to lease-in aircraft with crew from foreign airlines. Yet, the agreement still fails to treat wet-leasing as a normal operational arrangement, in as much as it does not affect the policy of the U.S., not shared by most other countries, that the lessor must hold commercial authority to serve the route in question. While such a requirement may be

appropriate in the case of blocked-space arrangements, where each party holds out the service to the public under its own name, it disregards the nature of a normal wet-lease, in which the lessor merely provides equipment and crew but without intention to exercise any traffic rights.

► Several reasons have been advanced to explain and justify the U.S. reluctance to change its policy in these areas. Labor concerns, national security risks and safety requirements are usually mentioned. Of course, these matters need due consideration. The question, however, is whether legitimate objectives in these areas require a policy of this type, which has such significant trade restrictive effects. It would seem that in this respect there is room for serious doubt.

► In fact, to rule out categorically cabotage and the right of establishment, while at the same time insisting that airlines should have full 5th and 7th freedom cargo rights is not particularly convincing. Of course, in legal terms cabotage and the right of establishment are not in the same category as 5th or 7th freedom rights. But air transport is not – and should not be – about abstract legal categories but about tangible commercial opportunities. And in commercial terms there is little difference between a U.S. express operator wishing to carry local cargo traffic between Singapore and New Zealand and a non-U.S. cargo airline wishing to do the same between Miami and Seattle:

- As U.S. labor benefits from such commercial opportunities for U.S. airlines abroad, why should employees of non-U.S. airlines not be allowed to benefit from similar commercial opportunities for their companies in the U.S. (apart from the fact that all stand to benefit from open markets)?

- Or why would a non-U.S. cargo airline that may freely serve destinations in the U.S. in international air transport suddenly become a safety risk if on an otherwise empty leg operation from a U.S. inbound cargo airport to a U.S. outbound airport it would carry also some cabotage traffic?

- Moreover, why should a U.S. express operator, using full 7th freedom facilities, be free to set up business abroad and operate virtually as a local airline, without having to respect the local rules on establishment, while establishment for non-U.S. nationals in the U.S. under full application of the U.S. laws remains off limits?

► Also in the area of wet-leasing the present regulatory situation remains highly unsatisfactory, as it results in unfair competition and produces economic inefficiencies. While most countries follow relatively flexible policies in order to facilitate normal wet-lease operations, U.S. policy, notwithstanding the APEC agreement, continues to be much more restrictive, as foreign airlines can only act as lessors if they themselves hold economic authority for the operation in question. As a result, while U.S. carriers such as Atlas Air, Evergreen, Southern

and Polar Air have been able to build up significant wet-leasing business on a global scale, including operations carried out directly for foreign forwarders, non-U.S. carriers cannot match the competition, since the large U.S. market is closed to them. Also wet-leases between foreign airlines on routes to/from the U.S. are not without problems, due to the different requirements of the DOT and the FAA concerning commercial and operational authority. Even U.S. airlines are the victim of the restrictive U.S. wet-lease rules. For example, these rules prevented a U.S. express carrier to wet-lease from a European cargo carrier additional capacity needed to satisfy peak requirements in the U.S. market.

► There is no substantive and convincing evidence to support the view that the availability *per se* of cabotage rights, the right of establishment and reasonably flexible wet-leasing facilities would have detrimental effects on either U.S. labor, U.S. national security or U.S. aviation safety. Experience in the European Single Market only serves to confirm this. Any potential problems, such as the emergence of flags of convenience or unsafe wet-leases, can be dealt with effectively by enforcing the applicable safety rules. Likewise, experience in Europe strongly suggests that the availability of sufficient civil airlift capacity for national security purposes can be guaranteed without prohibiting foreign ownership and control of locally established airlines.

► In reality, U.S. policy in these areas, disregarding the principle of proportionality, is unnecessarily restrictive. Or in EC competition terms: the restrictions turn out not to be indispensable to the attainment of legitimate policy objectives. While the U.S. is excessively defensive and protectionist as regards the U.S. domestic air transport market, it is at the same time very liberal concerning the need to remove barriers to trade and competition in international air transport markets. In practice, this remarkable mix, in combination with the size of the U.S. market and the unparalleled negotiating strength of the U.S. to obtain access to foreign markets, produces neither a real 'level playing field' nor a truly efficient air transport system. Important differences remain in as much as:

- Lack of access to the relatively small domestic markets of other countries has a much less restrictive effect on U.S. airlines than the lack of access to the U.S. domestic market has on non-U.S. airlines.

- With respect to third country routes, which are liberalised both under open skies bilaterals and the APEC multilateral, the U.S. has generally much better chances than its bilateral or APEC partners to obtain the necessary additional traffic rights from third countries.

► There are important arguments for a more even-handed policy:

- A fundamental tenet of acquired economic wisdom is that markets know better than governments. U.S. deregulation and its 'open skies' policy are

based on this principle and have resulted in significant economic benefits for consumers, airlines, airports, local communities, labor and other aviation stakeholders, in the form of increased output at lower unit costs. To shield a sizable part of the U.S. air transport market from foreign competition is flatly inconsistent with this principle, apart from the fact that such a policy makes little sense at a time when there are concerns about the continued effectiveness of competition in the U.S. domestic market, in the light of the on-going consolidation of the U.S. airline industry. It is also inconsistent with the trade policies pursued by the U.S. and its major partners in other sectors of the economy, notably with respect to investment. Presently, the total stock of two-way investment in the U.S. and the EU amounts to about $300 billion, with each partner employing about 3 million people in the other. Why should air transport, which is otherwise treated on both sides of the Atlantic as a normal economic activity in an open market, continue to receive special treatment in this respect?

- There may be good reasons for maintaining, on a temporary basis, certain barriers to free competition in order to help an economically weaker airline to adapt to the rigor of the open market environment. However, there is no such justification in the case of economic giants such as the major U.S. airlines, which are already fully exposed to head-on competition both with each other and – in many international markets – with foreign airlines. Protecting in these circumstances the U.S. airlines domestically against foreign competitors, while insisting that free competition should prevail in international markets, makes economically no sense, distorts competition, undermines the credibility of U.S. international aviation policy, and is a recipe for conflict.

- Globalisation, removal of regulatory obstacles to market access, and increased competition are having a profound impact on the airline industry, including the U.S. airlines. These airlines, together with their European counterparts, are in the forefront of economic integration in the form of strategic alliances. At the same time, U.S. airlines also increasingly focus on global markets. Over the last 10-15 years their production in U.S. domestic air transport as a percentage of their total production (in scheduled ASKS) has decreased from more than 80% to less than 75%. As this process of integration and globalisation continues, the need for U.S. airlines and their strategic foreign partners to consolidate their joint business activities further under liberal trade and investment rules, both in the U.S. and elsewhere, will increase. Excluding foreign access to domestic air transport markets is counterproductive in this respect. It prevents the industry to achieve the efficiencies inherent to such further industry consolidation, through alliances and eventually mergers and acquisitions.

► An efficient air transport system requires a regulatory framework that eliminates the remaining artificial barriers to market access and entry and alleviates the regulatory burden on airlines as much as possible. To this end, the European airlines that are members of the AEA have proposed the establishment of a *Transatlantic Common Aviation Area* (TCAA). This proposal has achieved wide-spread support in Europe and constitutes the basis on which the EC Council of Ministers is currently preparing a negotiating mandate for the European Commission.

► From the outset, the geographical scope of such a new framework should be broad enough to act as a catalyst for regulatory reform on a global basis. The U.S. and the EU are best equipped to set this process of regulatory reform in motion. Between them they share some 50% of world air transport. A TCAA with the U.S. and the EU as initial parties should have sufficient critical mass to facilitate a progressively broader geographical coverage, with the ultimate objective of creating on this basis a worldwide aviation regime.

► The TCAA proposal seeks to create a true 'level playing field', by giving the airlines of each Party full freedom to provide services anywhere between and within the territories of the parties and by freely allowing their nationals to invest in airlines established in the territory of another party or to establish such airlines themselves. A prerequisite of an effective 'level playing field' is that such rights are only extended to third country airlines or third country routes if such countries accede to the TCAA. This is necessary to avoid undue advantages on the one hand for third country nationals and airlines over those of the TCAA parties and on the other hand for airlines of one TCAA party over those of the others. Of course, existing bilateral rights would not be affected by the TCAA.

► However, an efficient international air transport system requires not only the removal of artificial barriers to access and entry, but also the development of a harmonised regulatory framework. One of the great challenges of our time is the contrast between the new global economy and the far from global rules that govern the economy. The economy is rapidly integrating on a worldwide scale. This process strengthens competition and improves efficiency. At the same time, business is confronted with an ever broadening and ever more detailed range of local rules, which – because of a lack of coherence and commonality – reduce efficiency.

► This is an industry-wide problem. For example, in a recent position paper of the European services industry on e-commerce in connection with the WTO negotiations on services the problem is stated in the following terms: "E-commerce accelerates global economic integration. Unfortunately, there is a mismatch between globalisation of the economy and the lack of coordination of government policies. … Presently, there is no multilateral organization or mechanism for reaching a common approach or mutual recognition with respect to domestic regulatory regimes."

► One of the key objectives of the TCAA proposal is to create such a mechanism for regulatory convergence, in addition to removing remaining obstacles to free trade and investment in the air transport sector. Indeed, the much needed modernisation of the traditional air transport regulatory system provides an excellent opportunity for pursuing both liberalisation and harmonisation as the two basic pillars of a new regulatory approach.

► Some have interpreted the TCAA proposal for regulatory convergence as a *tsunami* of additional bureaucracy and a call for a new supranational regime. Nothing is further from the truth. The stated aim of the TCAA is to reduce the regulatory burden on airlines, by eliminating burdensome and unnecessary differences between the domestic aviation rules of the parties. Such differences obstruct smooth operations, by creating additional layers of bureaucracy and extra cost. On occasion, domestic rules are in conflict with each other, creating legal uncertainty or forcing airlines to adapt their commercial strategies to the level of the 'lowest common denominator'. In all cases, efficiency suffers.

► In air transport the potential scope for efficiency gains through regulatory convergence is significant, because the sector is highly regulated and airlines conduct their business in a multitude of different regulatory environments. For example, in the vast area of safety regulation significant cost reductions can be achieved through mutual recognition on a much broader scale and much better organized than at present, ranging from foreign maintenance and repair facilities to simulator qualifications, where currently each FAA double-check of a European JAA-approved simulator that is used to train U.S. pilots amounts to U.S.$ 35.000.

► In practice, the development of common rules, by way of either harmonisation or mutual recognition, will in many areas be time-consuming. It is also, of necessity, a dynamic, on-going process, because regulatory standards continue to evolve. It is therefore important not to be over-ambitious and to restrict initial convergence measures to a few key regulatory questions affecting core airline business activities, together with a mechanism to ensure that, once the TCAA is in place, the process of convergence be self-propelled and effective. AEA priorities for initial convergence are competition policy and the rules governing wet-leasing arrangements, where the U.S. and the EU currently apply divergent policies with major adverse consequences for airlines.

► The U.S. and the EU are well placed to start such a process of regulatory convergence between them. Both have a mature air transport regulatory framework and the ability to develop appropriate rules for any aspect of air transport. Cooperation between the U.S. and the EU for the purpose of establishing common rules would have a profound and beneficial effect on a much broader scale, because in practice any common rules developed between them would become the standard to be followed by all parties to the TCAA.

► Clearly, no convergence can be achieved without both the U.S. and the EU being prepared to re-assess their own rules in the light of the experience of the other and where necessary to modify these rules. That cannot be a one-way street, where one side takes over the rules of the other. That being said, there can be no doubt that the U.S., with its long term experience in aviation rulemaking and its pragmatic approach to regulatory questions, would considerably influence the process of convergence and play a major role in developing an effective and efficient common regulatory framework for the TCAA, as an alternative to the regulatory fragmentation that characterises much of today's air transport system.

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